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SOUTH KOREA: THE ECONOMY IN AFTERMATH OF PAK'S DEATH [redacted]

Business is proceeding normally in Seoul following the death of President Pak Chong-hui last Friday. The interim government has stressed that economic policy will remain intact, and the initial reaction in the international financial community does not reflect concern. If an orderly transfer of power occurs and political stability is established, disruptions to the economy should be minimal. [redacted]

The next president of South Korea will nonetheless face a difficult set of economic problems, including an economic slowdown, high inflation, and rising unemployment—the same economic conditions that contributed to President Pak's recent political difficulties. [redacted]

The View From Seoul

The interim South Korean Government is attempting to maintain a business as usual approach to domestic and international economic activities in the aftermath of the death of President Pak Chong-hui. Following Pak's death last Friday, the Deputy Prime Minister and Economic Planning Board chief, Sin Hyon-hwak, announced that economic policy would remain intact. Sin made it clear that the government will guarantee free overseas economic activity and international trade relations and protect foreign economic activities and investments in Korea. According to Sin, price stability will remain the government's top economic priority. Business in Seoul reportedly has been proceeding as usual; all shops have remained open. [redacted]

The International Reaction

Available information indicates the international financial community is taking a calm view of the developments in South Korea. [redacted] An orderly transition of power and political stability, however, will be essential if Seoul is to maintain its easy access to international financial markets at favorable terms. [redacted]

The Economy Awaiting the New President

The successor to President Pak will have to come to grips with difficult economic problems. The fast growing South Korean economy, long a political plus for President Pak, had turned against the government in 1979. Since the second quarter of the year the economy has been in the midst of a business slump with rising bankruptcies and high inflation. Labor unrest grew as cash short companies were forced to lay off workers and failed to meet payrolls. [redacted]

The 1979 economic difficulties stem in large part from imbalances that developed during the past three years of exceptionally fast growth. Real GNP grew 12.3 percent annually between 1976 and 1978, marking the first time South Korea had achieved three consecutive years of double digit growth. The expansion was largely investment fueled; real fixed investment rose 27.3 percent per year between 1976 and 1978. In 1978, investment grew a remarkable 40 percent; investment in machinery and equipment was up 51 percent. [redacted]

Domestic demand provided much of the growth stimulus. Buoyed by real wage increases of 18 percent annually between 1976 and 1978, consumer spending rose sharply, especially for electrical appliances and autos. The South Korean consumer also used his increased disposable income to upgrade his diet; beef consumption, for example, rose 44 percent in 1978. [redacted]

The South Korean economy, however, became overheated by 1978 and inflation reached levels well above those in Korea's major trading partners. Consumer prices rose 14.4 percent last year, according to the official index which understates the increase. The GNP deflator, a better indicator of the true inflation rate, rose 20.6 percent. The upward price spiral, in turn, began to erode Korean export competitiveness and became an increasing source of public criticism. In response, the Pak government implemented a tough anti-inflationary stabilization program in early 1979 to slow the economy. The measures included tight monetary and fiscal policies, continued import liberalization, and postponement of some of the country's industrial expansion plans. [redacted]

The economy was dealt a further blow by this year's OPEC oil price increases. South Korea depends on imports for 100 percent of its oil supplies, which in turn account for about 60 percent of total energy consumption. In addition to directly adding $870 million to Seoul's oil import bill, this year's oil price increases resulted in an acceleration in Korean inflation—adding about 5 percentage points to the wholesale price index—and reduced demand for Korean exports. [redacted]

The Next Government's Likely Policy Directions

Regardless of who comes to power, we expect South Korean economic policy to remain basically unchanged in the near term. Controlling inflation will remain the top priority of any new government. [redacted]

On the international front, Pak's successor will put priority on maintaining lender confidence in the Korean economy. [redacted]

Foreign Capital Requirements

The importance of maintaining lender confidence is underscored by the heavy inflows of foreign capital Seoul will need to finance large payments deficits. Import liberalization, higher oil prices, and less rapid export growth will lead to a $3.4 billion current account deficit this year—three times as large as the 1978 shortfall. Through September, exports were only 21 percent above 1978 levels because of a slowdown in the Middle East development boom, increased protectionism in the developed countries, and a weakening in Korean competitiveness. All of the increase is due to higher prices; export volume was down 3 percent in the first half of the year. Imports, on the other hand, are running 44 percent ahead of 1978, reflecting a liberalization of Seoul's trade barriers and higher oil and raw material costs. Imports have risen sharply across the board with especially large advances in capital equipment and food and grain purchases. [redacted]

Seoul has a large pipeline of funds and should have no trouble financing this year's deficit. Another current account deficit on the order of $3.5 billion appears likely next year. Principal repayment requirements and the need to add to foreign exchange reserves means Seoul will have to attract some $5 billion to $6 billion in foreign long- and short-term capital in 1980. [redacted]

Outlook

If an orderly transition of power occurs and political stability is established, we expect only minimal disruption to the economy. An extended period of political turbulence would create serious disruptions, especially affecting Seoul's ability to freely tap the international financial markets at favorable terms. [redacted]

The new Korean leadership will, in any event, face slower real growth, a rise in unemployment, and continued high inflation as the effect of this year's stabilization measures and higher energy costs work through the economy. Barring serious political instability, we expect:

- Real GNP to grow about 6 percent between mid-1979 and mid-1980.

- Unemployment to reach about 4.2 percent of the labor force at yearend 1979, compared with a 3.2-percent average in 1978.

- Consumer prices to increase about 20 percent this year with only a slight reduction in 1980. [redacted]

The less buoyant Korean economic outlook will add to the challenges facing the next government. A high level of bankruptcies raises the possibility of further labor unrest. [redacted] Meeting the rising expectations of the populace for an even higher standard of living will also be more difficult as the economy grows less rapidly. [redacted]

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